DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER 00-0256
FINANCIAL INSTITUTIONS TAX
For Years 1996 and 1997

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ISSUE

I. **Taxpayer's Qualifications to File Under Indiana's Financial Institution Tax**: Conducting the Business of a Financial Institution.

Authority: IC 6-5.5 et seq.; IC 6-5.5-1-17(d)(1); IC 6-5.5-1-17(d)(2); IC 6-5.5-1-17(d)(2)(B); IC 6-5.5-3-1; IC 6-8.1-5-1(b); 45 IAC 17-2-1(a); 45 IAC 17-2-3(d)(1), (2); 45 IAC 17-2-4(b), (c); 45 IAC 17-2-4(b), (c), (e)(2); 45 IAC 17-2-4(e)(2); Rev. Rul. 55-540, § 162(4) 1955-2 CB 39; Rev. Proc. 75-21, § 4, 1975-1 CB 715.

Taxpayer is protesting the audit's decision, based upon taxpayer's relevant qualifications, to change taxpayer's filing status from a FIT-20 status to that of a IT-20 regular filer.

Statement of Facts

Taxpayer is in the business of leasing and financing the purchase of construction equipment and engines throughout the world. Taxpayer's primary method of earning income is from leasing and rental activity. The taxpayer is a Delaware corporation with its headquarters located outside Indiana. Taxpayer's Indiana activities include the rental, leasing, and sale of equipment within the state. However, the taxpayer does not maintain a sales office within Indiana.

I. **Taxpayer's Qualifications to File Under Indiana's Financial Institution Tax**: Conducting the Business of a Financial Institution.

DISCUSSION

The taxpayer has protested audit's decision to change the taxpayer's filing status from that of an FIT-20 filer to an IT-20 regular filer. The taxpayer maintains that, because it is in the business of leasing and financing construction equipment, it qualifies as a financial institution based on 45 IAC 17-2-3(d)(1)(2). The taxpayer argues that it qualifies to file as a financial institution because, as required under 45 IAC 17-2-4(b), (c), more than 80% of its total gross income is derived from leasing that is the economic equivalent of extending credit. Taxpayer maintains that the auditor's decision was based upon an incomplete consideration of its qualifying interest income.

Indiana imposes a franchise tax, known as the Financial Institution Tax (FIT), on corporations transacting the business of a financial institution inside the state. IC 6-5.5 et seq. The tax is imposed on resident financial institutions, nonresident financial institutions, and to non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as the taxpayer, transacting the business of a financial institution, are included in the FIT, when they meet one of the eight tests listed in IC 6-5.5-3-1 whereby the non-resident corporation demonstrates that it has established an economic presence in Indiana. For the purpose of determining whether a taxpayer is qualified to file as a FIT, the taxpayer will have established an economic presence in Indiana if the taxpayer:

> (1) maintains an office in Indiana; (2) has an employee, representative, or independent contractor conducting business in Indiana; (3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana; (4) regularly solicits business from potential customers in Indiana; (5) regularly performs services outside Indiana that are consumed within Indiana; (6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer within Indiana; (7) owns or leases tangible personal or real property located in Indiana; or (8) regularly solicits and receives deposits from customers in Indiana. IC 6-5.5-3-1.

It is not disputed that the taxpayer, under the provisions of IC 6-5.5-3-1, has sufficiently demonstrated that it maintains an economic presence in Indiana.

Because the taxpayer is not conducting the business of a traditionally regulated financial institution as defined in IC 6-5.5-1-17(d)(1), the taxpayer bases its claim to FIT status under the provisions of IC 6-5.5-1-17(d)(2)(B) which grants FIT status to those corporations which obtain 80% of their gross income from the "leasing [of] real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes." Id.

That definition is amplified in the Department of Revenue regulations. A corporation is subject to the FIT if it is conducting the business of a financial institution. 45 IAC 17-2-4(b), (c). The benchmark for determining whether the taxpayer is conducting the business of a financial institution is if 80% of the corporation's gross income is derived from the economic equivalent of extending credit. Id. The corporation must not only derive 80% of its income from garnering interest, that interest must be derived from a lease that is "*not* treated as a lease for federal income tax purposes." 45 IAC 17-2-4(e)(2) (Emphasis added). Therefore, to satisfy the 80% benchmark, the interest must be both "the economic equivalent of the extension of credit" and from a lease "*not* treated as a lease for the federal income tax purposes." Id.

The taxpayer, looking to qualify as a FIT filer, is required to demonstrate that the transactions from which it derives interest income are not true leases but financing leases. A financing lease appears on the surface to be a lease and may be labeled as such but in substance is simply a device which enables the lessor to retain a security interest in the property until the purchase price is paid by the lessee. In effect, under a financing lease, the lessor is making a conditional sale to the lessee. IRS Revenue Ruling 55-540 provides the guidelines used in determining the treatment of equipment leases for use in the trade or business of the lessee. Whether a lease agreement is a lease, or in reality a conditional sale, depends on the provisions of the agreement in light of the facts and circumstances existing at the time the agreement was executed. Rev. Rul. 55-540, § 162(4) 1955-2 CB 39. In the "absence of compelling persuasive factors" demonstrating otherwise, a transaction is a conditional sales contract if one or more of the following factors are present:

> (1). Portions of the periodic payments are specifically applicable to the equity to be acquired by the lessee;
>
> (2) the lessee acquires title upon a payment of a stated amount of rentals which under the contract the lessee is required to make,
>
> (3) the total amount paid by the lessee for a relatively short period of use constitutes an inordinately large proportion of the total payments required to secure transfer of title,
>
> (4) the rental payments materially exceed the fair rental value,
>
> (5) the property can be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time the option may be exercised or which is a relatively small amount when compared to the total,
>
> (6) some portion of the payments is specifically designated as interest or is otherwise recognizable as the equivalent of interest. Id.

IRS Revenue Procedure 75-21 expands on Revenue Ruling 55-540 by elaborating on the facts and circumstances that indicate whether a transaction is, in contrast to a conditional sale, a true lease. A transaction will constitute a true lease if *all* of the following conditions are met;

> (1) The lessor must have a minimum unconditional risk investment in the property at the inception of the transaction,
>
> (2) the lessor must maintain the minimum at risk investment throughout the lease and that risk must remain at the end of the lease,

(3) the minimum at risk investment must be equal to at least 20% of the cost of the property and must remain at 20% throughout the entire lease term,

(4) and, there must be a residual investment of at least 20% at the end of the lease term. Rev. Proc. 75-21, § 4, 1975-1 CB 715.

The taxpayer must meet its burden of proof by demonstrating that the proposed tax assessment, requiring the taxpayer to file under IT-20, is incorrect. IC 6-8.1-5-1(b) states in relevant part that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with person against whom the proposed assessment is made."

The taxpayer has presented evidence that purports to establish that, during the 1996 and 1997 tax years, it received interest income that exceeded the 80% benchmark figure required under IC 6-5.5-1-17(d)(2). The documentary evidence is labeled as "Transactions as a Percentage of Gross Income per Tax," "Transactions as a Percentage of Assets Per Book," and "Transactions as a Percentage of Assets Per Tax." The taxpayer represents this information as establishing yearly interest percentages ranging between 86.99% to 93.25%. However, for purposes of establishing the prerequisites necessary for filing under the FIT, the information is either irrelevant or inadequate. Taxpayer needs to establish that 80% of its income derives from income that is the economic equivalent of extending credit and that, in taxpayer's situation, the interest income derives from a particularized type of "lease." 45 IAC 17-2-4(b), (c), (e)(2). There is no indication that taxpayer's interest income is received from transactions which qualify as conditional sales under IRS Revenue Ruling 55-540 or that the income is not simply derived from true leases under Revenue Procedure 75-21. The documentary evidence offered by the taxpayer may be of some arcane significance but it does not enable the taxpayer to meet the statutory burden of demonstrating the proposed assessment is incorrect.

In addition, a cursory review of the taxpayer's 1996 and 1997 federal tax returns indicate that the taxpayer is ineligible to qualify to file under the Indiana FIT. The amount of interest and rental income claimed on those returns does not approach the 80% threshold requirement. Further, there is no indication that the interest income listed on the federal returns is derived from the economic equivalent of extending credit.

FINDING

Taxpayer's protest is respectfully denied.